Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:UNY:TL-N-3313-99
RMBoulanger

date: JUN 29 1999

to: [redacted]

from: District Counsel, Buffalo

subject: [redacted]/Applicability of I.R.C. § 956

DISCLOSURE STATEMENT

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This memorandum is in response to your request for advice concerning the above-referenced taxpayer. Specifically, you are requesting guidance as to whether or not pursue your belief that [redacted] ("taxpayer") had an investment in "United States property" pursuant to I.R.C. § 956 by virtue of certain "comfort letters" issued by its foreign subsidiaries.

It is our position at this time that you should pursue and develop this issue since it appears that these "comfort letters", issued by the taxpayer's foreign controlled subsidiaries, may very well constitute "United States property" for the purposes of I.R.C. § 956.

DISCUSSION

The facts are briefly as follows:

Taxpayer is a U.S. [corporation] that owns [redacted]% of the stock of a [redacted] Corporation. The [redacted] Corporation owns [redacted]% of the stock of two corporations incorporated in [redacted]. Additionally, the taxpayer controls [redacted] other foreign corporations.

Taxpayer wanted to build a new manufacturing facility in [redacted] and borrowed $[redacted] from [redacted]. Additionally, taxpayer obtained a revolving line of credit from the same lender for $[redacted].

[redacted] required taxpayer to guarantee payment of the loans by pledging assets and to obtain "comfort letters" from its subsidiaries. Two such letters were in fact issued by the taxpayer's subsidiaries.

Taxpayer's operations in [redacted] were its largest foreign operations. [redacted] had $[redacted] in cash and over $[redacted] in untaxed earnings and profits. Therefore, a separate "comfort letter" was obtained from the taxpayer's two [redacted] subsidiaries. The other letter was issued on behalf of all subsidiaries other than [redacted].

In the letter to [redacted], the two [redacted] subsidiaries acknowledged that they would perform certain acts in consideration of [redacted] lending [redacted] $[redacted] dollars. The [redacted] companies agreed, among other things, to:

- → Monitor on an ongoing basis, the financial soundness of the borrower to meets its obligations.
- → Provide the borrower with sufficient liquid assets via a cash dividend to meet those obligations.
- → Take necessary steps to ensure the net worth of the borrower is maintained at not less than $[redacted] at all times.
- → Subordinate any existing and future indebtedness of the taxpayer to the [redacted] subsidiaries to [redacted].

LAW GENERALLY

Section 951(a)(1)(B) of the Code requires, under certain circumstances, that a shareholder of a controlled foreign

corporation include in its gross income its pro rata share of the corporation's increase in earnings invested in United States property. Section 956(a)(1) provides that:

The amount of earnings of a controlled foreign corporation invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend . . . if it had been distributed.

The purpose of section 956 of the Code is to terminate the tax deferment privilege with respect to the earnings of controlled foreign corporations when such earnings are directly or indirectly repatriated. S. Rep. No. 1881, 87th Cong., 2d Sess. 80, 87-88 (1962), 1962-3 C.B. 707 at 794, states, in part, "Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them."

There are four specific categories of "United States property" for purpose of Subpart F:

(1) tangible property located in the United States;
(2) stock of domestic operations;
(3) obligations of U.S. persons; and
(4) intangibles used in the United States.

I.R.C. § 956(c)(1).

The third class, obligations of related U.S. persons, is the pertinent portion for our review.

Pledges and Guarantees

A controlled foreign corporation (CFC) is treated as an owner of any obligation entered into by a U.S. person for which it serves directly or indirectly as a pledgor or guarantor. Treas. Reg. § 1.956-2(c). As a result, the controlled foreign corporation may own "United States property" for tax purposes even though the corporation nominally does not own any such property. Treas. Reg. § 1.956-2(c)(1).

A CFC that acquires an item of "United States property" through a genuine pledge or guarantee is treated as owning the entire unpaid principal amount of the U.S. person's obligation, regardless of whether that amount exceeds the amount of its pledge. Treas. Reg. § 1.956-1(e)(2).

The regulations apply the pledge rule if the assets of a controlled foreign corporation ***indirectly*** secure the obligation of a U.S. person. Treas. Reg. § 1.956-2(c)(2). That would result, for example, if the controlled foreign corporation agrees to buy the U.S. person's obligation at its face amount in the case of default. Treas. Reg. § 1.956-2(c)(3), Ex. 2.

Based upon the limited facts and documents so far presented, the "comfort letter" issued (at least with respect to the [redacted] subsidiaries) appears to fall within the definition of "United States property". Therefore, it is our position that your proposed adjustment has merit and that you should pursue its development.

In addition, you have requested guidance as to how to properly develop the issue.

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Finally, please be advised that the I.R.S. Restructuring Act of 1998 makes significant changes to the third-party summons rules. Among the more important changes, the Service is now required to give the taxpayer advance notice of a "contact" with a third party. I.R.C. § 7602(c).

Should you have any questions regarding the above, including the new summons procedures, please contact Ray Boulanger of this office at 551-5610.

EDWARD D. FICKESS
Assistant District Counsel